



HOUSE BUDGET COMMITTEE

Democratic Caucus

The Honorable John M. Spratt Jr. # Ranking Democratic Member

214 O'Neill HOB # Washington, DC 20515 # 202-226-7200 # www.house.gov/budget_democrats

September 25, 2001

Long-run Budget Outlook Must be Considered in Anti-terror and Economic Recovery Proposals

Dear Democratic Colleague:

After the tragic events of September 11, our nation faces an unprecedented challenge. We all agree that we must provide every dollar needed to win the war against terrorism and to ensure the security of Americans wherever they may be. We also must assess the condition of our economy after this enormous dislocation, and if necessary, provide a stimulus to growth.

But in addressing these new and urgent priorities, we must remember the unprecedented challenges that we faced even before September 11. Today, Social Security and Medicare face the same long-term budgetary pressures from population aging, and from the impending retirement of the baby-boom generation. Furthermore, the wide range of uncertainty in the budget outlook that we pointed out early this year is if anything markedly wider now. Without compromising our vital commitments, we must ensure that any policy changes, whether increased spending to fight terrorism or tax cuts to stimulate the economy, address these new short-term challenges without unduly worsening our continued long-term problems.

To help in this effort, the House Budget Committee Democratic staff has provided the attached analyses of the budget outlook. These two exercises are in no way intended as actual estimates of the most likely budget outcome; the Congressional Budget Office will provide such a new estimate early in 2002. Although the assumptions underlying these exercises are all highly plausible, our staff has tried to illustrate hypothetical scenarios closer to the extremes in the range of likely outcomes. In one scenario, both economic and policy developments are in the favorable range; in the other, all developments are more adverse.

Perhaps the most important lesson of these scenarios is that fully plausible economic developments, including especially a decline in the ratio of tax receipts to GDP from its current near-record high to its level of just two years ago, could markedly cut the projected budget surpluses. Under even the optimistic scenario, the unified surplus in 2002 would essentially be eliminated. If the Congress then enacted large permanent drains on the surplus to address recent short-term economic concerns, the unified surplus — including the surpluses in Social Security and Medicare — could be fully exhausted for several years, and we could see the return of unified budget deficits.

This analysis is designed to put recent and future policy proposals into a broader context, and to warn everyone of where the current trends in fiscal policy may lead.

Sincerely,

John M. Spratt, Jr.
Ranking Democratic Member



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Large, Permanent Commitments and a Downward Budget Revision Could Cause Unified Budget Deficits, and Rising Public Debt

The attached tables illustrate two hypothetical scenarios describing how the 10-year budget surplus could change due to an altered economic outlook, plus new tax cuts and spending in response to the terrorist attacks on September 11. One scenario assumes uniformly favorable developments and thus provides an outcome toward the optimistic end. The other is based on more adverse developments and illustrates more pessimistic possible outcomes. The scenarios illustrate the two primary dangers with regard to the long-term budget outlook: (1) a downward revision of the projected surplus due to the reversal of those factors that caused the upward revisions in recent years; (2) large, permanent tax cuts and spending increases, layered on top of the large tax cuts already enacted.

Both scenarios show that even modest changes in assumptions about the responsiveness of the federal budget to the economy can significantly reduce the projected 10-year surplus. In particular, even minor changes in the ratio of revenues to GDP can cause the unified surplus to shrink significantly. With such shrunken surpluses, even limited initiatives to address terrorism, economic stimulus, and other priorities can push the unified budget into deficit for years to come.

The optimistic scenario shows that a fairly small downward revision of the baseline surplus, combined with a relatively restrained fiscal response to the terrorist attacks, would essentially eliminate the unified surplus in 2002. Any initiatives in addition to that — a farm bill, extension of expiring tax credits, or natural disasters — would push the budget into unified deficit. If no other demands were put on the budget, unified surpluses would return but would be severely constrained for the next few years. However, the budget under this optimistic scenario still spends the entire Medicare surplus and almost 30 percent of the Social Security surplus for the next decade.

The pessimistic scenario shows that even a downward revision of the surplus somewhat smaller than the upward revisions seen in recent years, in combination with permanent tax cuts and new spending, would have dramatic effects on the budget outlook. In this case, the budget is pushed into unified deficit for the next four years and is quite small thereafter. The entire Medicare surplus and three-fourths of the Social Security surplus over the next decade are spent.

It is important to note that the 10-year baseline surplus in these scenarios declines even with no deterioration of the outlook for long-term economic growth. Both the optimistic and pessimistic scenarios assume an average recession followed by a prompt recovery to the long-term GDP path in the August CBO projection.

The largest difference between the two scenarios concerns their assumptions about the amount of revenues expected from any given level of GDP. The optimistic scenario assumes only a modest short-run decline in the ratio of revenues to GDP. The pessimistic scenario assumes that the ratio of revenues to GDP drops as it did in the 1990 recession and then slowly returns to its 1999 level by 2008. If the ratio returned to its 1997 or 1998 level, the downward revision would be well over \$1 trillion, even with the same economic performance.

For the last three years, CBO has increasingly assumed that the ratio of revenue to GDP will stay quite close to the record levels of recent years. As a consequence, CBO has added trillions of dollars to the baseline surplus largely on the basis of unexpected — and to some extent unexplained — jumps in the amount of revenues coming in at any given level of economic activity. These trillion dollar upward revisions were criticized at the time as speculative — extrapolating the unusually favorable experience of only four years out to the indefinite future.

Now, there are reasons to believe that the ratio of revenues to GDP may decline more than CBO previously assumed. The recent record levels of revenues relative to GDP may well have been keyed to the extraordinary stock market performance of the late 1990s. Stock prices have now fallen dramatically and may stay low given the uncertain climate going forward. As a consequence, tax revenues related to surging income from capital gains, stock options, bonuses, and corporate profits may now dwindle.

It also is important to note that the policy changes shown in the tables do not include many popular spending initiatives and tax cuts. These initiatives, if enacted, would take the surplus even lower.

Optimistic Economics/Modest Initiatives

Fiscal Years	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2002-11</u>
August Unified Surplus adj. for 2011 sunset	153	176	172	201	244	289	340	389	450	507	567	3335
Less: Deterioration of Unified Surplus	12	68	42	19	9	8	9	10	10	10	11	195
Weaker Economic Growth	7	10	6	4	2	2	2	3	2	2	2	34
Change in Revenues/GDP	5	58	36	16	6	7	7	7	8	8	9	161
Possible New Unified Surplus	141	108	130	182	235	281	331	379	440	497	556	3140
Note: Invasion of Medicare Surplus	-29	-38	-41	-42	-11							-132
Note: Invasion of Social Security Surplus	-21	-66	-60	-22								-149
Less: Modest Initiatives Responding to Terrorism		105	87	66	57	66	70	74	79	83	88	775
June Defense Request		10	13	23	19	22	22	22	22	22	22	197
Additional Defense & Foreign Aid Request		10	13	23	19	22	22	22	22	22	22	197
Recovery Spending (50% Defense)		20	15	5								40
Airline Rescue (incl. Victims Compensation)		10	5									15
Airport Security		3	3	3	3	3	3	3	3	3	3	30
Economic Stimulus		50	30									80
Associated Debt Service		2	8	12	16	19	23	27	32	36	41	216
Equals: Remaining Unified Surplus	141	2	44	115	179	215	261	305	362	414	468	2364
Note: Invasion of Medicare Surplus	-29	-38	-41	-42	-42	-45	-43	-41				-292
Note: Invasion of Social Security Surplus	-21	-172	-146	-89	-45	-27	-1					-480
Less: Claims on the Surplus Inevitable Before 9/11/01		10	17	20	29	43	58	71	87	107	120	560
Natural Disasters		2	4	5	6	6	6	6	6	7	7	55
Farm Bill		7	8	8	8	7	7	6	6	7	7	71
Tax Extenders		1	4	5	9	12	14	16	18	21	21	121
Alternative Minimum Tax					2	12	22	30	39	48	54	207
Associated Debt Service	0	0	1	2	4	6	9	13	18	24	31	106
Equals: Remaining Unified Surplus	141	-8	27	95	150	172	204	234	275	307	348	1804
Note: Invasion of Medicare Surplus	-29	-38	-41	-42	-42	-45	-43	-43	-42	-39	-19	-394
Note: Invasion of Social Security Surplus	-21	-174	-163	-109	-74	-70	-58	-49	-28	-16		-741

Pessimistic Economics/High-Cost Initiatives

Fiscal Years	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2002-11</u>
August Unified Surplus adj. for 2011 sunset	153	176	172	201	244	289	340	389	450	507	567	3335
Less: Deterioration of Unified Surplus	12	126	111	99	85	68	50	31	32	33	35	671
Weaker Economic Growth	7	10	6	4	2	2	2	3	2	2	2	34
Change in Revenues/GDP	5	115	106	96	83	67	49	28	30	31	33	637
Possible New Unified Surplus	141	50	61	102	159	221	290	358	418	474	532	2664
Note: Invasion of Medicare Surplus	-29	-38	-41	-42	-42	-45	-15					-223
Note: Invasion of Social Security Surplus	-21	-124	-129	-102	-65	-21						-441
Less: High-Cost Initiatives in Response to Terrorism	116	128	164	153	164	176	189	203	218	218	234	1744
June Defense Request		10	13	23	19	22	22	22	22	22	22	197
Additional Defense & Foreign Aid Request		20	26	46	38	44	44	44	44	44	44	394
Recovery Spending (50% Defense)		20	15	10	5							50
Airline Rescue (incl. Victims Compensation)		10	10	10	5							35
Airport Security		3	3	3	3	3	3	3	3	3	3	30
Economic Stimulus		50	53	55	58	61	64	67	70	74	78	629
Associated Debt Service		3	9	16	25	34	43	53	64	75	87	409
Equals: Remaining Unified Surplus	141	-65	-67	-62	6	57	114	169	215	256	298	920
Note: Invasion of Medicare Surplus	-29	-38	-41	-42	-42	-45	-43	-43	-42	-39	-31	-406
Note: Invasion of Social Security Surplus	-21	-174	-190	-204	-218	-185	-148	-114	-88	-67	-47	-1435
Less: Claims on the Surplus Inevitable Before 9/11/01	10	17	20	28	43	58	70	86	106	106	119	558
Natural Disasters		2	4	5	6	6	6	6	6	7	7	55
Farm Bill		7	8	8	8	7	7	6	6	7	7	71
Tax Extenders		1	4	5	9	12	14	16	18	21	21	121
Alternative Minimum Tax					2	12	22	30	39	48	54	207
Associated Debt Service			1	2	3	6	9	12	17	23	30	104
Equals: Remaining Unified Surplus	141	-75	-84	-82	-22	14	56	99	129	150	179	363
Note: Invasion of Medicare Surplus	-29	-38	-41	-42	-42	-45	-43	-43	-42	-39	-31	-406
Note: Invasion of Social Security Surplus	-21	-174	-190	-204	-224	-228	-206	-184	-174	-173	-166	-1924